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Fiscal Decentralization in Indonesia: The First Year in Review and the Challenges Ahead

Project 497-0357 / 104-000
Strategic Objective 1
ECG, USAID/Indonesia
Contract No. 497-C-00-98-00045-00

Center for Institutional Reform and the Informal Sector (IRIS)
University of Maryland at College Park

January 2002

USAID-funded Partnership for Economic Growth (PEG Project).

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Presentation by Roy W. Bahl
January 21 – 25, 2002

Introduction

Indonesia's new fiscal decentralization (FDC) policies have raised the country's sub-national government expenditure from 13% to roughly 35% of total government expenditure in the span of one year. (See attached ASEM chart.) That shift has moved Indonesia from the average expenditure level of developing countries to that of OECD countries in a very short, politically tumultuous timeframe. The IMF warned that such a drastic move would carry serious risks, such as the possible break-down of public service delivery and untenable increased pressure on the national deficit. Thankfully, those hazards seem to have been largely avoided. Indonesia should be credited with circumventing those potential difficulties and certain laudable choices in the early days of this fledgling policy.

Positive Results

Before looking at ways in which FDC policy might be improved, it is important to first acknowledge the positive strides that have been taken thus far. Six stand out in particular:

1. Implementation

   The FDC policy was implemented quickly and completely without lengthy deliberations beforehand. While some critics point to this as a liability, it is in fact to the country's credit and overall benefit that action was taken swiftly and without major incident.

2. General Purpose Grants

   Many countries are reluctant to give general purpose grants to the regions they seek to liberalize, but Indonesia has indicated its confidence in the regional governing authorities' abilities by distributing such grants to them. While the country may choose to revisit this issue shortly, it suggests that the central government strongly supports the concept of increased regional independence.

3. Formula Distribution

   The establishment of the DAU revenue formula adds a critical level of transparency to the reallocation of resources and provides a common baseline from which to consider possible future adjustments within the distribution framework.

4. Local Government Taxes

   With implications similar to those of the general purpose grants, the inclusion of local government taxation authority under the new policy grants the regions much greater control over their revenues and suggests a real commitment to the notion of regional authority.

5. <u>Special Autonomy</u>

   Throughout the world, it is common to confer special status on certain regions that differ markedly from the rest of their nation in either ethnic makeup or availability of resources. This has been the case in Russia and Nigeria, for example. Papua and Aceh stand apart from the rest of Indonesia in both categories, and it is thus reasonable and commendable that the central government has recognized their special circumstances through the new policies of Special Autonomy. These regions and their special status must form an integral part of the overall FDC policy framework.

6. <u>Parliament Involvement</u>

   An active parliamentary role in shaping and supporting the FDC process is intrinsic to any such move under a democratic system of government. Parliament's involvement may complicate matters for policymakers within the government ministries but gives the overall process much greater legitimacy.

Emerging Issues

Over the past year, eight critical issues have emerged that will require special attention as part of the effort to build a more consistent, workable FDC policy. Namely, these are:

1. <u>DAU Hold Harmless Provisions</u>

   The current DAU revenue formula includes "hold harmless" provisions to protect local governments from possible fiscal mismanagement, currently covering approximately 80% of each local government's budget. These provisions act as additional buffers on top of separate provisions guaranteeing that no regional government will receive less revenue under the new formula than it did in 2000.

   These protectionist measures make good sense in the early stages of transition to protect existing services as local governments adjust to new budgetary conditions. But it remains unclear how long such measures should hold, to what degree they should be phased out, and what the timeframe for such a shift might be.

2. <u>Contingency Fund</u>

   Similarly, the contingency fund which has been established to safeguard the regions against possible revenue shortfalls should not be allowed to continue indefinitely. If a clear timeline for phasing out the fund is not established shortly, it runs the risk of becoming institutionalized and inhibiting the decentralization process.

3. <u>Local Taxes</u>

   Local governments must have local taxing authority to exercise control over local trade and revenues. But the taxing authority granted under Laws 22, 25 and 34 is too broad, while the regulations stipulated under Law 18 are too narrow – and in some cases even contradictory. The issue of local taxation must be reviewed shortly to determine which areas should fall within local governments' taxing jurisdiction and which should not. Typically, such taxes involve some combination of payroll, motor vehicles, and value-added taxes. Regardless of which ones Indonesia chooses, improved clarity and regulation on this issue is imperative.

4. Capacity to Absorb

The new FDC policy has granted extensive new governing powers to the regions with unprecedented speed and minimal guidance. These have challenged the regional governments' abilities to manage their newfound largess, and not all are equally equipped to do so. This in turn raises the questions of whether the same policy can be applied to all regions if they are differently prepared to handle the new responsibilities, and how regional capacity to absorb the new policy can be raised and equalized as swiftly as possible.

5. Hard Budget Constraints

As with the DAU hold harmless provisions and the contingency fund, Indonesia must consider how to legislate and enforce hard budget constraints on regional governments to hold them accountable for their budget management practices. Currently, no such constraints are in place and this may encourage irresponsible fiscal behavior from the local governing bodies.

6. Monitoring and Evaluation

A defined monitoring and evaluation system must be established hand in hand with the implementation of a FDC policy to ensure its long-term success. The United States, for example, has been tinkering with its regional policy for over 200 years and still hasn't found a final balancing point. In fact, it is unlikely that it ever will as the policy must be able to evolve with the country's own changes and development. Likewise, FDC policy in Indonesia must be formally and closely monitored with regular analysis and evaluation to ensure that the structure matures and changes to match the country's evolving needs.

7. Coordination at the Central Level

Strong central government leadership is a crucial ingredient for successful long-term decentralization. The central government must continue to oversee the overall process to ensure fairness, full compliance, and continued unity in deference to national goals. Without such cohesion radiating from the center, the FDC process risks devolving into a fragmenting force with negative implications for national growth.

8. Natural Resources and Special Autonomy

The redistribution of natural resource revenues has been one of the primary catalysts for the implementation of the new policy and should continue to feature prominently in the overall policy strategy. Any long-term FDC policy adjustments must take into account the special needs and legal status of the country's two resource-richest and most ethnically contentious provinces, Aceh and Papua.

Choices

Upon review of the above eight issues, it follows that Indonesia's policy makers will need to make some difficult choices in the near future to solidify and improve their long-term FDC policy. Considerable debate and analysis will be required to determine which choices will best serve Indonesia's long-term needs and these choices are likely to be modified over time as the country evolves. But preliminary evidence of the above problems emerging from the policy in its current incarnation suggest that some initial choices and adjustments must be made shortly to avoid exacerbating current difficulties.

The key choices to be made are as follows:

1. DAU: Negotiated or Formula?

   To what extent should the DAU be negotiated, either over time or by region, and to what extent should it be formulated?

2. Grants: General Purpose or Conditional?

   How much authority over local revenues should be granted to local governments? To what degree should their revenues be controlled by the central government – earmarked for certain services or purposes the central government deems essential and does not want to leave at the regions' discretion to dispense – and to what extent should the regions be able to determine their own spending priorities?

3. Local Tax List: Prescribed or Residual?

   How much discretion should be granted to local government to set regional tax policy? Should such taxing authority be carefully prescribed or residual? Which levies should be left within local government's taxing jurisdiction and which should remain under central or provincial control?

4. Natural Resource Sharing: How Much?

   How should natural resources and the resulting revenues be allocated, and how should this change over time if at all?

5. Expenditure Responsibility: Districts and Provinces?

   How should expenditure responsibility be portioned between local districts, regions and provinces and to what extent should different policies apply to different areas of the country?

6. Local Budget Management: Hard Budget Constraint or Paternalism?

   To what degree should local governments be held accountable for managing their own budgets and to what degree should the central government continue to oversee and buffer them? What safeguards should be provided and for how long?

Conclusion

There are no absolutes in these deliberations, and determining the best course of action will depend largely on the nation's future objectives and aspirations for the overall fiscal decentralization process. The development of a strategic framework setting forth these guiding principles and ultimate goals is urgently needed to lead the policy's evolution and stimulate public dialogue on the issue. Such a framework is a prerequisite for determining which among the above choices best suit the nation's long-term interests, and its development is essential before any additional measures are taken to alter current policy.

Drafted by Stephanie Lowy.